UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In Re:	:	08-11153 (MG)
LEXINGTON PRECISION CORPORATION,	:	One Bowling Green
	:	New York, New York
Debtor.	:	April 2, 2008

TRANSCRIPT OF MOTIONS
BEFORE THE HONORABLE ARTHUR J. GONAZALEZ
UNITED STATES BANKRUPTCY JUDGE

APPEARANCES:

For the Debtors:	MARCIA GOLDSTEIN, ESQ. Weil, Gotshal & Manges LLP 767 Fifth Avenue New York, New York 10153
For the Ad Hoc: Bondholders Committee	PAUL SILVERSTEIN, ESQ. Andrews Kurth LLP 450 Lexington Avenue New York, New York 10017
For Lubin Partners:	GERALD C. BENDER, ESQ. O'Melveny & Myers LLP 7 Times Square New York, New York 10036
For the U.S. Trustee:	Office of the United States Trustee BY: PAUL SCWARTZBERG, ESQ. TRACY HOPE DAVIS, ESQ. Assistant United States Trustee 33 Whitehall Street New York, New York 10004
For Webster:	SCOTT A. ZUBER, ESQ. Day Pitney, LLP 200 Campus Drive Florham Park, New Jersey 07932

(Appearances continued on next page)

APPEARANCES CONTINUED:

For Capital Source: Funding	AARON R. CAHN, ESQ. Carter, Ledyard & Milburn LLP 8 Wall Street New York, New York 10005
For Secured Lenders:	JOHN TISHLER, ESQ. Waller, Lansden, Dortch & Davis LLP Nashville City Center 511 Union Street Nashville, Tennessee 37219
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THE COURT: Please be seated. All right.

The debtor. Go ahead.

MS. GOLDSTEIN: Good morning, Your Honor. Marcia Goldstein of Weil, Gotshal & Manges on behalf of the debtors.

Your Honor, the debtors are Lexington Precision and Lexington Rubber Group, Inc., which is a wholly-owned subsidiary of Lexington Precision.

Your Honor, we are here -- you know the background from Judge Glenn -- solely at this time with respect to the proposed cash collateral motion, proposed cash collateral order and our motion to approve a DIP financing.

I had understood that Your Honor wanted to talk about the timing?

THE COURT: Yes. There are two issues I must deal with; one is that Judge Glenn as best I understand has recused himself from the DIP financing aspect of the case at least for the moment because of -- who is here from O'Melveny?

MR. BENDER: Gerald Bender, Your Honor.

THE COURT: All right. Because O'Melveny was representing the DIP lender? Is that correct?

MS. GOLDSTEIN: Yes, that is correct, Your Honor.

THE COURT: I must disclose as well and, no, it's not to disqualify, that my daughter will be an associate there at O'Melveny in September.

MS. GOLDSTEIN: It's a very popular law firm, Your

Honor.

THE COURT: The last couple of days, yes, in the bankruptcy court.

The second piece is the scheduling. What do you need in terms of time to try to work things out?

MS. GOLDSTEIN: Well, we believe, Your Honor, that we have worked out issues -- well, we've worked out all issues with the secured lender on cash collateral, I believe, at this point; that we've clarified -- I think my associate went to tell the assistant U.S. Trustee that we're back here, she was in a hearing with Judge Bernstein -- but we believe that we've worked out all matters with respect to the U.S. Trustee, all clarifications.

I understand from Mr. Silverstein, who represents an ad hoc committee of bondholders that he has a slight objection to the DIP. You know, obviously given that this is the -- there are no encumbered assets of this company so the debtor in order to operate does need relief under these motions. We contemplate, obviously, interim relief, we hope, today and setting a final hearing the week of -- the earliest date that that could be on fifteen day's notice would be April 16th so we would like the final hearing as early as possible on or after April 16th.

So those were the timing issues. Obviously, the debtor will need to be using cash as soon as possible. Checks

will be clearing -- payroll checks. We have a payroll also, I believe, to be made this week so that this is of critical importance.

THE COURT: All right. But do you still need time to try to work any issues out or has that been exhausted at least at the moment?

MS. GOLDSTEIN: I don't think that Mr. Silverstein has any specific points to work out.

MR. SILVERSTEIN: I don't have specific -- well, there's one specific point to work out that I'd like to explain to the Court.

MS. GOLDSTEIN: I don't know what it is --

THE COURT: Well, my point is I need to set a schedule. Everybody ready to go forward right now and whatever efforts have been made to work it out have been exhausted and I just need to hear what the issue is?

MR. SILVERSTEIN: Yes.

MS. GOLDSTEIN: I think so, Your Honor.

THE COURT: All right. Then we need the U.S. Trustee's Office.

MS. GOLDSTEIN: Okay. With respect to the U.S. Trustee, she has -- we have incorporated all changes that the U.S. Trustee has suggested. However, we were dealing with language issues with the secured lender up until we filed and so we then provided a blackline to the U.S. Trustee's Office

and they haven't had a full opportunity to review the blackline changes. So while we don't think those are material we would be happy to go back in terms of the order and clarify anything that they raise with respect to those changes which really were issues between us and the secured lender. As I said, we don't think they were material but she still hasn't had a chance to review everything and she may, indeed, have an issue and she has reserved her rights.

THE COURT: All right. Do you have any indication from her whether or not she would be ready at eleven o'clock? How much time do they need to --

MS. GOLDSTEIN: She's at a hearing in front of Judge Bernstein, Your Honor.

THE COURT: Right.

MS. GOLDSTEIN: I mean we could let her know that.

MR. SILVERSTEIN: I think she's in a hearing in connection with the appointment of an examiner which I'd be shocked if that was done by 11:00. I mean I'm in that case but I think I can reasonably say it's not going to be over by 11:00.

MS. GOLDSTEIN: Perhaps we can hear every other issue that's raised. I mean I think the only other party raising anything may be Mr. Silverstein and, you know, if we still have an issue with her, come back, but I hope we can work out the U.S. Trustee's issues.

MR. SILVERSTEIN: Your Honor, that probably makes sense for the issues that the ad hoc bondholders committee --

THE COURT: All right. Mr. Silverstein, you're going to have to use either a microphone on the table or move to the podium.

MR. SILVERSTEIN: I think what Ms. Goldstein says makes sense. Perhaps -- I understand Your Honor has this case very temporarily. It's sort of a drive-by hearing if you will, I'm mindful of that and I just need to give you a context for where this arises and then to raise several points that we have in respect of the DIP. It's not a particularly protracted or long presentation.

THE COURT: All right. Ms. Goldstein, why don't you go through -- I don't have a blackline copy at this point, do I? Is there one in a binder?

MS. GOLDSTEIN: Your Honor, the binder is up-to-date but for one change that was really inadvertent and it dealt with notice of any termination event. This was a point raised by the U.S. Trustee which we had agreed to and the secured lender had agreed to and on Page 20 -- let me hand you the revised one.

THE COURT: All right. Thank you.

MS. GOLDSTEIN: On Page 20 we have added language which was inadvertently left out that the revolver agent and the term loan agent shall serve notice of any termination event

on the debtors, the U.S. Trustee, the committee and if no committee is yet appointed on the top twenty creditors holding unsecured claims. But this is clearly is agreed to. It was asked for by the U.S. Trustee. No one has had any issue with this. There were other blacklines that arose in the last day or so that the U.S. Trustee had not had time to fully review and I can now tell you the one issue she did have was that in the carve out, particularly for the creditors committee, in the current draft there is allocated only $25,000.00 to investigate the secured creditors' liens. She did not feel that was high enough and so we do have an issue there and I'm hoping that we can compromise that issue, hopefully, before the end of the day or as soon as she's available.

THE COURT: All right. What happened with the 506(c) issue? Is that still in this -- the waiver --

MS. GOLDSTEIN: Not for the interim hearing, Your Honor.

THE COURT: All right.

MS. GOLDSTEIN: That is in there subject to final hearing.

THE COURT: All right.

MS. GOLDSTEIN: Now, Your Honor, I can give an overview of where we are.

THE COURT: Why don't you do that and then I'll hear whatever objections or objection --

MS. GOLDSTEIN: Or I also have a proffer of testimony of Mr. Warren Delano, who is the co-chief executive officer of the company in support. So I'll give a very short overview and if Your Honor permits I can then go to the proffer.

THE COURT: All right. Go ahead.

MR. SILVERSTEIN: Your Honor, may I? Are we going with cash collateral now or DIP now?

MS. GOLDSTEIN: We basically have prepared one proffer for both because they work together. We're seeking approval of both, they're in one motion, obviously there are two different components but from the debtor's point of view the combination of the cash collateral and the proposed DIP loan is the proposed method of financing the company.

MR. SILVERSTEIN: Your Honor, I do not have an objection to cash collateral usage on an interim basis. So I guess I'll have to see how the proffer comes out. My issues are with the proposed DIP loan.

THE COURT: All right.

MS. GOLDSTEIN: Okay. We'll cover both, Your Honor.

THE COURT: We'll get there.

MS. GOLDSTEIN: Your Honor, prior to the commencement date which was yesterday the debtor's operation were funded through a revolving credit facility and borrowings under that revolving credit facility terminated upon the commencement date. As a result, the debtors need to fund its operations and

costs and expenses of administering these Chapter 11 cases through cash received from their operations and from supplementary post-petition financing.

All of the cash received by the debtors from its operations constitutes the pre-petition lender's cash collateral. After extensive negotiations the debtors and the pre-petition senior lenders reached a consensual agreement regarding the use of cash collateral and that is one piece of what we are seeking approval of today.

We have summarized the terms of the cash collateral and the DIP motions in the motion and, of course, the terms are also set forth in the proposed interim order. We'll cover some of those terms in Mr. Delano's proffer.

Now, although many of the terms of the proposed use of cash collateral are common to cash collateral stipulations there are certain provisions that are very specific to this case and these will in fact be specifically covered through the proffered testimony. In addition to the provisions specific to this case the agreed terms on the cash collateral contain two provisions that are normally considered extraordinary; the granting of adequate protection liens on Chapter 5 causes of action and the waiver of the 506(c) Bankruptcy Code provisions. These proposed extraordinary provisions are not part of the interim relief and would not be effective until entry of a final order. They were requested by the pre-petition senior

lenders as part of the overall agreement to use cash collateral and the debtors submit and believe that the agreement was negotiated at arm's length and in good faith. So those would be considered at the final hearing.

In addition to the use of cash collateral, the debtors propose to obtain an additional $4 million in post-petition financing. The post-petition financing in this case is no typical for two particular reasons; the DIP lenders are not the pre-petition secured lenders and although two of the DIP lenders are either insiders or affiliates of an insider, the third lender is not an affiliate of either the debtor's or the other DIP lenders. The lenders are Michael A. Lubin, who is chairman of the board and a co-CEO of the companies; William B. Connor, another director on the board and ORA Associates LLC, an entity that is not affiliated with the debtors or the other DIP lenders. Second -- and this is perhaps the more unusual part -- the DIP lenders have agreed to provide this financing on an unsecured super priority basis. They have further agreed that their super priority claim will be junior to the administrative expense claim that the pre-petition secured lenders will receive for the diminution of their interests in the cash collateral but the DIP lenders have agreed that payment of DIP loans other than payment of interests of fees will be subordinated to the payment of the pre-petition obligations owed to the pre-petition secured

lenders.

The interim relief sought with respect to the DIP loan is to seek approval to use $2 million of the $4 million and at this time I would like to offer the testimony of Warren Delano, the co-CEO and president of the debtors in support of both motions. Mr. Delano is present in the courtroom today.

THE COURT: All right. The question I have is the DIP lenders are agreeing to be junior to the pre-petition lenders and administrative --

MS. GOLDSTEIN: The secured lenders.

THE COURT: Secured lenders for purposes of an administrative claim.

MS. GOLDSTEIN: Yes.

THE COURT: But do they have a super priority administrative claim with respect to other administrative claims?

MS. GOLDSTEIN: Yes.

THE COURT: All right. Go ahead.

MS. GOLDSTEIN: So they are proposing a super priority claim, junior only to the super priority claim we would give to the pre-petition secured lenders.

With respect to the proffer, Mr. Delano is here in the courtroom and pursuant to Federal Rule of Evidence 103(a)(2) this Court may accept that proffer in lieu of testimony and I would request permission to do so.

THE COURT: All right. Go ahead.

MS. GOLDSTEIN: Mr. Delano, who is the co-CEO and president of Lexington is thoroughly familiar with all material aspects of Lexington's day-to-day operations, business and financial affairs and has been integrally involved with the negotiation of the cash collateral and DIP financing arrangements. If Mr. Delano were called to testify in support of the cash collateral and DIP motions his direct testimony would be as follows: Mr. Delano would testify as to his educational background; that he received a bachelor of arts degree from Harvard University in 1974. He, thereafter, worked as a commercial loan officer specializing in problem loans and in the early 1980s he worked for Norton Simon, Inc. in the area of strategic planning, worked as a loan officer at Bankers Trust Company. Since 1985, Mr. Delano along with Mr. Lubin, worked as workout consultants with troubled companies and for the last five years they have focused exclusively on Lexington.

Mr. Delano would testify that he first became involved with Lexington in 1985 when he and Michael Lubin, the current chairman of the board of directors and co-chief executive officer made their first investments in Lexington through a limited partnership. Mr. Delano became a director in 1985 and has retained a seat on Lexington's boards ever since. Mr. Delano would testify that in 1987 he and Mr. Lubin took over the management of Lexington's businesses and for the past

21 years he has been integrally involved in the management of Lexington's businesses. Mr. Delano would further testify that he has been the president of Lexington since 1988 and co-chief executive officer since 1997.

Mr. Delano would testify that as of the commencement date Lexington had amounts outstanding under several secured term and revolving credit facilities which I'll refer to as the pre-petition senior credit facilities. Mr. Delano would testify that the pre-petition senior credit facilities were secured by essentially all of Lexington's property including accounts receivable. Mr. Delano would also testify that prior to the commencement date all of Lexington's operations were funded through the revolving credit facilities, that every night the agent under the pre-petition revolving credit facility would sweep Lexington's lock box accounts into which accounts receivables were received in order to pay down the revolving credit facility and would periodically make advances under the revolving credit facility requested by Lexington. Mr. Delano would testify that as a result of filing these Chapter 11 cases the lenders under the pre-petition senior credit facilities which I will refer to as the pre-petition senior lenders have refused to make further advances under the revolving credit facility. Mr. Delano would testify that as a result the debtors seek authority to fund their operations and pay the costs and expenses of administering these Chapter 11

cases through the use of the pre-petition senior lenders' cash collateral and the supplementary post-petition financing.

Mr. Delano would testify that prior to the commencement date Lexington prepared thirteen week budgets int the ordinary course of business that Lexington delivered to its agents for its pre-petition senior credit facilities and that Mr. Delano was involved in the preparation of those budgets. Mr. Delano would testify that he was likewise involved in preparing the latest budget that's attached as Exhibit A to the cash collateral DIP motion. Mr. Delano would testify that based on previous budgets prepared by Lexington this budget reasonably predicts the debtor's cash-in flows and expenditures and is accurate to the best of his knowledge. Mr. Delano would testify that the use of cash collateral and proceeds of the proposed post-petition financing will be sufficient to pay the costs and expenses of administering these Chapter 11 cases.

Mr. Delano would testify that after several weeks of extensive negotiations with the pre-petition senior lenders of which Mr. Delano is part, Lexington and the pre-petition senior lenders agreed on the proposed terms for use of the cash collateral. Mr. Delano would testify that the pre-petition senior lenders were represented by multiple counsel for the different lenders, all of whom were involved in the negotiations. Mr. Delano would testify that the negotiations with the pre-petition senior lenders were at arm's length and

were done in good faith. Mr. Delano would testify that these negotiated terms of the use of cash collateral are accurately summarized in the cash collateral DIP motion and in the proposed interim order. Mr. Delano would testify that the terms of the use of cash collateral that were agreed to with the pre-petition senior lenders include certain terms that are particular to this specific Chapter 11 case. He would testify that under the proposed terms the debtor's use of cash collateral will be closely tied to the budgets, such that use of cash collateral will terminate if, for example, actual cumulative expenditures for a particular period exceed 110 percent of the budgeted expenditures or if net sales for a particular period are less than ninety percent of the budgeted net sales. Mr. Delano would also testify that use of cash collateral will terminate if without written consent of the pre-petition secured lender and orders entered providing for the sale of assets valued at more than $1 million that does not require the proceeds of such sale be applied to pay the pre-petition senior credit facilities.

Mr. Delano would testify that based on his review of the budget and his knowledge of Lexington's operations, these termination events are reasonable and not likely to be [inaudible -- someone coughing]. Mr. Delano would also testify that in addition to other triggering events use of cash collateral will terminate if the debtors fail to file a plan of

reorganization within ninety days of the commencement date, file a disclosure statement with respect to such plan within 120 days of the commencement date and consummate such plan within 270 days of the commencement date.

Mr. Delano would testify that these time lines are reasonable because if it's a balance sheet restructuring rather than an operational restructuring the debtors intend to propose a plan as quickly as possible. Mr. Delano would testify that although the debtors believe that the pre-petition senior lenders are oversecured, they further believe that it is cost effective and in the best interests of their estates, the creditors and shareholders that they reach a consensual rather than a litigated resolution regarding the use of cash collateral. Mr. Delano would testify that as a result Lexington agreed to provide the pre-petition senior lenders the adequate protection proposed in the cash collateral and DIP motion. Mr. Delano would testify that the proposed adequate protection consists of the following: adequate protection payments equal to current payment of interest at the contractual, non-default rate. The contractual, non-default rate is LIBOR plus two and a half percent for the revolving credit facility, LIBOR plus four percent for the equipment loan, LIBOR plus four and a half percent for term loan A, prime, which under the document is no less than five percent plus six percent for the term loan B.

In addition, as adequate protection there will be payment of agents' and lenders' legal fees and expenses up to certain limitations under the agreement and without prejudice to the lender seeking reasonable fees and expenses under Section 506(d) of the Bankruptcy Code and the debtor's rights to challenge such request and in consideration for the pre-petition senior lenders waiving until the occurrence of a termination event, any right they may have to an additional two percent of interest that would be payable if interests were paid at the contractual default rate, the debtors agreed to continue making principal payments due under the pre-petition senior credit facilities which amounts to $269,000.00 a month.

Mr. Delano would testify that it is in the best interest of the debtor's estates, its creditors and shareholders to continue to make scheduled principal payments under the pre-petition senior credit facilities in lieu of paying an additional -- or possibly paying an additional two percent in interest pending confirmation or a termination event.

Further, the pre-petition senior lenders will to the extent of the diminution in value of their interests in the cash collateral receive replacement liens on all of the debtor's property including proceeds of the post-petition financing and subject to entry of the final order Chapter 5 causes of action. Mr. Delano would testify that liens on both

of these were required by the senior lenders as part of the overall agreement.

Finally, the pre-petition senior lenders will to the extent of the diminution and the value of their interests in the cash collateral receive an administrative priority expense claim under Section 507(b) of the Bankruptcy Code which will be senior to the super priority claim proposed for the post-petition lenders but subject to the carve out for court fees, fees for the Chapter 7 Trustee in the amount of $100,000.00 if these cases are converted to Chapter 7 and after termination of the use of cash collateral, allowed fees and expenses of professionals in an amount not to exceed $400,000.00.

With respect to the proposed DIP loans, Your Honor, Mr. Delano would testify that the debtors need to obtain post-petition financing because based on the budget use of cash generated by operations post-petition will be insufficient to fund operations and pay the costs and expenses of administration of these Chapter 11 cases. Mr. Delano would testify that Lexington was able to obtain post-petition financing in the amount of $4 million, that two of the three proposed post-petition lenders, Lubin Partners LLC and William B. Conner, are either insiders or affiliates of insiders of the debtors. Mr. Delano would testify that he is not a DIP lender and is not affiliated with one. Mr. Delano would testify that even though two of the three proposed post-petition lenders are

either insiders or affiliates of insiders of the debtors the DIP loans were negotiated ar arm's length and in good faith. Mr. Delano would testify that the proposed DIP lenders were represented by counsel and that negotiations of the terms of the DIP loans and the DIP lenders' counsel took place over the course of a couple of weeks. Mr. Delano would testify that the terms of the proposed DIP loans are set forth in the form of a note which is attached as Exhibit B to the cash collateral DIP motion. Mr. Delano would testify that the form of the note accurately reflects the terms of the DIP loans negotiated with the DIP lenders and that each of the DIP loans will be made pursuant to a note that will be substantially in the form of the note attached to the motion.

Mr. Delano would testify that although the debtors seek to borrow an aggregate of $4 million under the DIP loans, they seek to borrow $2 million on an interim basis pending entry of the final order. Mr. Delano would testify that although the budget does not project the entire $2 million being used up within the next two and a half weeks, approximately $1 million is projected to be used. He believes that it is necessary that Lexington have cash on hand as a cushion during both of these periods, both the interim period and the period thereafter. Mr. Delano would testify that the debtors' only other source of cash, accounts receivable, tend to fluctuate and may come in lower than expected. Mr. Delano

would also testify that as recent events in the marketplace have shown, perceptions about a company's ability to pay its obligations are often more important than the company's actual ability to pay its debts. Accordingly, Mr. Delano would testify that Lexington needs to have extra cash on hand at all times so that customers and suppliers are confident that Lexington would be able to meet its obligations. Mr. Delano would testify that maintaining suppliers and customers is especially important so that suppliers can continue to sell goods to Lexington on credit.

Mr. Delano would testify that the DIP loans are term loans payable only on the maturity date which is the earlier of the one year anniversary of the commencement date or the occurrence of certain events such as conversion or dismissal of these Chapter 11 cases or acceleration of the notes by the DIP lenders after an event of default. Mr. Delano would testify that it's the debtor's intent to exit bankruptcy expeditiously and that a one year term for the DIP loan is reasonable in this case.

Mr. Delano would testify that this is a somewhat unique type of post-petition financing and that the DIP loans are being provided on an unsecured super priority basis but are contractually subordinated to the obligations owing the pre-petition senior lenders. Mr. Delano would also testify that in light of the DIP loans being unsecured the DIP lenders required

that the DIP loans be entitled to a super priority claim status pursuant to 364(c)(1) of the Bankruptcy Code payable from all property of the debtors and senior to any and all other unsecured claims. The DIP loans, however, would be junior, subordinate and subject to the pre-petition obligations owed to the pre-petition senior lenders, the liens thereon, the adequate protection liens and the claims proposed to be granted to the pre-petition senior lenders and the carve out which is substantially similar to the carve out that applies to the pre-petition senior lenders.

Mr. Delano would testify that interest on the DIP loans is payable monthly at a rate of LIBOR plus seven percent per annum with a LIBOR floor of three percent. Mr. Delano would testify that because LIBOR rates are below three percent, the current one month LIBOR being 2.7 percent, the current interest rate on the DIP loans would be ten percent. Mr. Delano would testify that Lexington asked its financial advisor, W.Y. Campbell, to collect data on interest rates, applicable and comparable post-petition financings. Mr. Delano would testify that based on his conversation with W.Y. Campbell the post-petition financing sought to be approved in this case is very unusual and exact comparables are difficult to find. Mr. Delano would testify, however, that based on one other recent post-petition loan and the interest rates applicable to recent loans obtained by or offered to Lexington the interest

rate on the proposed DIP loans is reasonable in light of its unsecured subordinated status. Mr. Delano would testify that he is aware of only one post-petition loan that would at all be comparable which was approved in the Chapter 11 case of Eagle Pitcher Incorporation, its second Chapter 11 case, which had an interest rate of LIBOR plus twelve and a half percent for a $50 million loan secured by a third priority lien. The interest rate on the proposed DIP loans is lower than the rate in the Eagle Pitcher's post-petition loan which was secured, although by a third priority lien. In addition, Mr. Delano would testify that even a better comparable are the secured loans that Lexington obtained in 2006 from the pre-petition senior lenders and which are still outstanding. Mr. Delano would testify that the interest rate on the $4 million term loan B carries an interest rate that is currently higher than the proposed DIP loan -- prime rate plus at least six percent which currently equates to 11.25 percent -- even though term loan B is secured and is in a better position than the DIP loans.

Moreover, Mr. Delano would testify that the financing proposal Lexington obtained prior to the commencement date in connection with a potential out-of-court restructuring carried an interest rate of LIBOR plus six percent for the bottom portion of the loan even though that loan would be secured by all assets of the companies.

Accordingly, Mr. Delano would testify that the

interest rate on the DIP loans provided in this case is reasonable in light of the unsecured and subordinated nature of the DIP loans. Mr. Delano would testify that as consideration for making the proposed DIP loans, the proposed DIP lenders will receive a fee in cash in the aggregate amount of $80,000.00 which amounts to two percent of the total DIP loans. Mr. Delano would testify that the debtors seek approval to pay only $40,000.00 on an interim basis with the remainder to be sought in the final hearing. Mr. Delano would testify that he has reviewed fees given to post-petition lenders in other cases and has concluded that the $80,000.00 fee to be paid to the DIP lenders in this case is much lower than the average fees of other cases. Mr. Delano would testify that this two percent fee is very reasonable in light of the unsecured and subordinated nature of the DIP loans.

Mr. Delano would testify that because the pre-petition senior lenders have liens on and security interest in substantially all of the debtor's real estate and other assets, the debtors are unable to obtain the funds to be provided under the DIP loans on more favorable terms than those proposed by the DIP lenders. Mr. Delano would testify that the debtors would be unable to obtain funds on an unsecured, non-super priority basis even if administrative priority were granted. Mr. Delano would testify that the DIP lenders would only lend on a super priority basis. Mr. Delano would testify that

considering the current market conditions and because the debtors have virtually no unencumbered assets the debtors believed it would be more efficient and cost effective to seek the loan on terms that a lender would likely agree to rather than incur the costs and expenses to search for a lender that is not willing to provide an unsecured loan on a regular administrative priority basis. Mr. Delano would also testify that the debtors in their sound business judgment determined that it would be extraordinarily difficult and costly to obtain financing on a secured basis.

Mr. Delano would also testify that because the proposed DIP loans have no break-up fees, no prepayment penalties or other provisions that would prevent some other lender coming to provide post-petition financing the debtors would welcome any other proposals for DIP financing that contain better economic terms.

Your Honor, the only limitation on that is in the cash collateral order that would have to be agreed to by the senior secured lender.

Your Honor, that concludes the testimony with respect to both the proposed use of cash collateral and the proposed terms of the DIP loan.

THE COURT: Mr. Delano is here?

MS. GOLDSTEIN: Yes, Mr. Delano is here and is available.

THE COURT: All right. What I'm going to do is ask that he be sworn in and then I will ask him if the statements made by counsel would be his direct -- you can stay there, you don't need to come to the witness box -- would be your direct testimony if called upon to testify and then ask if you want to make any modifications, additions, changes, etc., and then offer you for cross-examination. If someone wants to cross-examine you then you would come to the stand.

(Warren Delano, Debtor's Witness, Sworn.)

THE COURT: All right. Were the statements made by counsel on your behalf be your direct testimony if you were called upon to testify?

THE WITNESS: Yes, it would have been.

THE COURT: All right. Does anyone wish to cross-examine the witness?

MR. SILVERSTEIN: Your Honor, I think I'd like to make a few statements and then I think we can discuss whether it's necessary or appropriate to cross-examine. I'd like to reserve the right to cross-examine after I give argument, this is a first day hearing on an interim basis and I understand the context of the time constraints and the context of Your Honor having this case on a, perhaps, limited basis. So if I can explain what I'm thinking and if I could explain the arguments maybe that could segue into whether we do or do not take testimony but at this point I'd like to reserve because I think

there are a lot of contradictions in Ms. Goldstein's proffer. They may not all be germane on an interim basis though, so if I could have the opportunity to explain that might be helpful.

THE COURT: All right.

MR. SILVERSTEIN: Thank you.

First, I'm Paul Silverstein of Andrews, Kurth, counsel to the ad hoc bondholders committee.

Your Honor, I need to put this situation in context. The case filed yesterday. The case as a restructuring has been going on for approximately a year and a half. In May 2007, my clients entered into a forbearance agreement because there was a payment default under the bond indenture. There's approximately $43 million presently owed to creditors under that indenture and there is a payment default.

The reason that this company was not put into proceedings at that point was that my clients entered into a forbearance agreement under which the company agreed that they shop the business and sell the business as a whole and pay the creditors off. There was never a discussion or agreement that the company would sell pieces of the business. Subsequently, in September 2007 an extension of the forbearance agreement was also entered into with the same understanding; that the business would be sold and the creditors would be paid.

If you look at the capital structure here, although this is technically a public company it's fundamentally a

closely-held company controlled by Messrs. Delano and Lubin who collectively hold over fifty percent of the stock. They also hold some subordinated debt, they also hold, I believe, in the range of twenty percent of the outstanding bonds that my clients own. Essentially, our view on this case -- and, again, I understand the context of this being first day hearings on a case so I understand this is not the time for the full explanation -- but essentially what this case is about is management/stockholders keeping control of their business -- of their candystore -- and at the same time not paying or satisfying the claims of creditors. That being said, Your Honor, the cash collateral we have no objection to because obviously the debtor has to operate using the proceeds of its receivables. The ad hoc committee has been in contact throughout the last eighteen or nineteen months with Capital Source, the pre-petition secured lender.

Our objection is to the DIP on a couple of reasons; (1) it's not clear that the debtor in fact actually needs a DIP loan. The proffered testimony was that the budget suggests they might need it but it's really more important for cushion and perception of having access is more important to the trade than actually needing the money, which there is some truth to that, there's some truth to the statement that it's nice to have a cushion so that the trade believes that you have money available to you. The problem is that when the insiders who

were essentially trying to keep control of this company and essentially have the bondholders end up as their minority stockholders going forward is that the proposed DIP lenders have an easy piece of paper that at a certain point they can say it has to be converted to equity and, therefore, it's an additional part of our control over the business.

THE COURT: But that piece of paper -- well, I may over simplify it but it seems circular -- if they don't need the money and they don't use it, then they're not owed very much from the estate.

MR. SILVERSTEIN: That's true.

THE COURT: So what advantage do they then get? The only advantage they seem to get is if they use it and, presumably, if they use it they needed it.

MR. SILVERSTEIN: Correct. But the problem here is that this DIP has not been shopped and the proffered testimony from Ms. Goldstein was that Mr. Delano consulted with W.Y. Campbell with respect to appropriate interest rates, whether other DIP loans were available. There's no basis and no foundation for suggesting that W.Y. Campbell has any experience in bankruptcy and any experience in DIP loans.

But let me get to my point that really gets us to where we are today. If on solely an interim basis the debtor believes that it needs a DIP loan that can easily be replaced if it's necessary at a final hearing -- because there are folks

out there who would fund a DIP loan on better terms than is being offered by Mr. Delano and Mr. Lubin -- that option ought to be preserved.

THE COURT: I thought it was preserved or at least I heard a statement to that effect.

MR. SILVERSTEIN: I have not seen that in an order. I heard some vague statement that if anyone wants to do better, they can do better, but I want to be explicit that there are people who have expressed --

THE COURT: There's nothing that prohibits that from happening in any order --

MR. SILVERSTEIN: Then I particularly in that case don't really think it's appropriate for the full half of the commitment fee of $40,000.00 to be paid up front, that ought to wait until the final hearing on the DIP. I don't think it's necessary at this point to actually pay them $40,000.00 for a DIP that either may be replaced or may not be used, No. 1, (2) there is a covenant in the DIP that prohibits any sales, mergers, liquidation, leasing, disposing of assets -- it's on Page 11 and I don't know what binder tab you have, Your Honor, I have a different numbering. It's (x) in the covenant section, it's on Page 11 of the --

MS. GOLDSTEIN: Tab 14.

MR. SILVERSTEIN: Tab 14, Your Honor, Page 10.

That Covenant A should not be there because it's not

appropriate if this DIP ends up finally approved by this Court at a subsequent hearing.

THE COURT: Fine. So that's -- do you agree that that's an issue for a final hearing or you're saying I need to rule on that now?

MR. SILVERSTEIN: I think you should not include that now and say that any covenants such as that should wait for a final hearing because it's not appropriate now and basically what's happening here as I can see -- and, again, it's very early in the case and we've not seen the financials of the company recently so we don't know as a matter of fact whether they need the money or not or how necessary a DIP is, if it turns out a DIP is necessary we're going to have to deal with that, but I think that should not be in the DIP at this point in time and my point, Your Honor, is that the DIP, I believe, is being used strategically. If I'm wrong, I'm wrong, but it seems to me that all rights of creditors need to be preserved on this issue and if the debtor's testimony is that they need the cash I can understand that the Court is not in a position to say, you don't need the cash, because I don't have evidence today to say they don't need the cash, but this should be approved with the most minimal provisions for the lenders. The lenders are getting a super priority. At present, I'm not going to object to the ten percent interest rate on the DIP. The LIBOR is set at three plus seven. But there should not be

bells and whistles such as this covenant.

That's basically the position. This case is, again, an eighteen month old case out of court. There's a history in this case. If a DIP is done solely on an interim basis without any bells and whistles, without any advantage to the insiders who are essentially as I said before, you know, fighting to save their little candystore that they live off, that's fine but more than that is not appropriate under the circumstances.

THE COURT: You're saying the covenants on Page 11, subparagraph (x) --

MR. SILVERSTEIN: Yes, subparagraph (x), subparagraph (a) within the Romanette ten, within the (x), "To enter into any transaction or consolidation to convey, sell, lease, sublease, transfer, otherwise dispose of," I mean that's a serious provision for a DIP loan and it's not appropriate particularly on an interim basis at this point and I don't think it's necessary and I don't think the debtor would credibly argue that they need it. It's a very bad message to my clients and I don't think Your Honor needs to approve that so if Your Honor is going to approve a DIP loan as I suspect you will I think it has to be approved on the most minimal standard super priority interest rate, no fees at this point, and so again, as to the cross-examination, I think that's probably taking up too much of your time, Your Honor, because this is interim-interim and very preliminary.

THE COURT: There's a lot of modifiers there.

MR. SILVERSTEIN: There's a lot of modifiers and I apologize for that.

THE COURT: All right. Ms. Goldstein.

MS. GOLDSTEIN: Your Honor, I would like to respond to a few points.

I think the first point made by Mr. Silverstein is that the testimony that I proffered on behalf of Mr. Delano indicated that the DIP loan in the interim was needed only as a cushion. That was not the testimony. If I may repeat, the testimony was that while the debtor does not anticipate using all of the $2 million, the budget attached to the motion shows that there will be a shortfall of approximately $1 million in the interim period and that it would be critical because I think that as we all understand, particularly at the beginning of a case, there will be fluctuations particularly in receivables collections, particularly in how much trade credit the company gets. So having the extra million available would be very important to the stability of the debtor.

So we're not just talking about a cushion that's nice, we're talking about actually projecting a use of a million and really needing to have the excess to prevent shortfalls. So that's the first response.

The concerns expressed by Mr. Silverstein about management entrenchment, etc., that really has nothing to do

with this DIP loan. This is a one issue case, Your Honor. This is about ultimately at the end of the day allocation of equity. This is not an operational restructuring. Unfortunately, this has been bifurcated so we had discussion in front of Judge Glenn earlier today about the fact that the pre-petition solicitation of bids for this company indicated that the market value of the assets were significantly in excess of the debt. There is no intention here to keep debt, to keep equity and not pay creditors, indeed, the intention is to file a plan promptly that provides full value to all creditors and preserves a certain amount of equity for the current equity.

So I don't think we need to characterize the insiders, we don't need to characterize the management. There is nothing in this DIP loan that requires conversion to equity. In fact, the DIP lenders -- the documentation requires that they get paid just like any other DIP lender. So we are not here today to presume what the plan negotiations will be like, these are plan issues; what the capital structure will be, how to value the recovery to the bondholders. That will all be taken up not in connection with certainly this interim DIP hearing but at the appropriate time when we talk about plans and disclosure statements.

With respect to the covenant that Mr. Silverstein is talking about, let me point out that that is not an unusual covenant. What it says is that you can't sell assets without

paying the DIP loan. It doesn't say you can't do it and if Mr. Silverstein would like a representation from me as counsel that we are not filing any motion to sell assets between now and the final hearing I will give that with my client's blessing. That's not what this case is about. If there is a motion to sell assets they can object to it because we can't do that without coming to court. We can't sell assets out of the ordinary course of business without coming to court. All this says is that the DIP lenders would be paid unless they agree otherwise. This is a fairly standard provision.

The other thing I'd like to point out is that the fact that we have two insiders participating as DIP lenders, the terms of it being subordinated with a super priority claim and unsecured were disclosed to Mr. Silverstein probably within the last two weeks. He made some indication that perhaps some of his clients would be interested but we have not received any indication of interest; no proposal, no term sheet to evaluate. Again, there is nothing in the DIP loan that would preclude this DIP loan being totally taken out and replaced by a DIP loan on better terms. As I said before, I think we would have to get the senior secured lender to agree. I couldn't imagine that if the terms were better or equal that they would have a problem but there is nothing in the DIP loan that is of any kind of strategic point. You know, the deadlines are not imposed by the DIP lenders in terms of the plan, they're

imposed by the pre-petition secured lender. The debtor didn't have a problem with any of that because they intend to move quickly with a plan and try to proceed as efficiently and as expeditiously as possible.

So I think, Your Honor, the only issue left is the fee. This is a loan that is going to be used. We project usage during the interim period. There isn't any reason whatsoever -- this is not a strategic play by anybody because we've assured the Court that other proposals will be entertained, no sales of assets are going to be made in the interim period but the fact that two out of the three lenders are insiders doesn't mean that they can't be fairly compensated for making this cash available. This cash is going to be used to support the operations and we're asking only for $40,000.00 which is half of the fee to be paid now and the other half to be paid later. Indeed, Your Honor, you've seen many DIP loans as have I where the bank demands the full payment of the fee in advance.

Mr. Tishler, counsel for the secured creditors is acknowledging that because I'm sure -- I think at one point we saw a DIP proposal from them and it would not have been on terms like this.

So, Your Honor, we would request that the DIP loan be approved on an interim basis. You have my representation that there will be no sales of assets and no motion to sell assets

between now and the interim hearing and, again, you have my assurance that the documents do not contain any provision required by the DIP lenders that would preclude an alternative that would preclude a take-out but in order to get money today and to have funds available between now and the first day that we could possibly have a final hearing which is April 16th the debtor really does need $2 million. It anticipates spending as much of about a million of that and we can't project. If receivables don't come in as projected, if there are customers who hold back or suppliers who don't give credit they may need to use more than that $1 million.

THE COURT: All right.

MR. SILVERSTEIN: Your Honor, very briefly, may I?

THE COURT: Go ahead.

MR. SILVERSTEIN: Thank you. Again, for the record Paul Silverstein of Andrews, Kurth for the ad hoc bondholders committee.

MR. SILVERSTEIN: Your Honor, I think Ms. Goldstein used the correct word, that my client's concern here is about entrenchment. That's what we believe this case is about and it seems to me that we don't want a DIP loan to have any impact on plan issues here and we want to make certain that replacing that DIP loan if it is approved on a final basis is cost effective and not made more difficult by payment of $40,000.00, albeit $40,000.00 does not seem like a huge amount of money it

adds up in a $2 million draw. So what we are concerned about is that it not change the dynamics and skew the dynamics toward the insider group that as I indicated before is attempting to entrench itself and control this company to the detriment of creditors.

Again, I know words are easy to say just as Ms. Goldstein's words are easy to say and we'll get to the details on those matters at a subsequent date. Today is not the day for that but I would urge Your Honor just to sanitize this interim preliminary DIP loan as much as possible by addressing the covenant, notwithstanding Ms. Goldstein's comments, and by addressing the fee.

Thank you.

THE COURT: All right. Now, what I'd like to do before I rule -- before I rule I was going to say the U.S. Trustee can have an opportunity to review whatever changes were made. It's my understanding that there were some changes made to reflect concerns raised by the U.S. Trustee that they hadn't seen the changes or were in the process of reviewing those changes?

MR. SCHWARTZBERG: Your Honor, Paul Schwartzberg from the U.S. Trustee's Office.

I don't think we've seen --

THE COURT: Fine. That's enough said.

I'll take a five minute break, take a look at the

changes. If you have any issues, when I come back out you can tell me and if we need more time I'll give you more time but their representation earlier before you were here was that the changes that were made reflect the concerns that were raised but we'll see.

MS. GOLDSTEIN: There are some additional ones, Your Honor, that need to be discussed.

THE COURT: All right. I'll come back at a quarter to twelve.

ALL ATTORNEYS: Thank you, Your Honor.

(Recess.)

THE COURT: Please be seated.

Ms. Davis, do you want to speak for Mr. Schwartzberg because I don't see him or should we wait?

MS. DAVIS: Your Honor, Mr. Schwartzberg was called back to Judge Peck's chambers [inaudible].

I know I didn't have the edification of hearing the prior proceedings with respect to the DIP but I am [inaudible]. Until he comes back [inaudible].

THE COURT: What?

MS. DAVIS: I'm going to sit in his place until he comes back if that's acceptable to Your Honor.

THE COURT: Well, no, the problem is we came back to specifically find out whether he had any problems with the changes that were made.

MS. DAVIS: All right. Well, I do not know and cannot speak to it. He's going to be back in maybe ten minutes. I'm sorry.

MS. GOLDSTEIN: Your Honor, we agreed to -- we believe that with one change that we've all agreed on that -- and I hate to speak for --

MS. DAVIS: Well, just one moment [inaudible].

MS. GOLDSTEIN: Yes.

MS. DAVIS: Is this for the committee carve out?

MS. GOLDSTEIN: Yes.

MS. DAVIS: That's fine.

MS. GOLDSTEIN: Okay. On the committee carve out issue, Your Honor, that I mentioned earlier, the draft that we had filed said that they could not exceed $25,000.00 to investigate the pre-petition secured creditors' liens. We've agreed to change that language to say that that would be an amount not to exceed an amount which would be negotiated with the committee.

MS. DAVIS: And that's acceptable to us, Your Honor.

MS. GOLDSTEIN: Our understanding is that with that change the U.S. Trustee has no other issues.

MS. DAVIS: That's correct, Your Honor.

THE COURT: Thank you. All right. So we have outstanding issues raised by the ad hoc committee.

With respect to the general issue of entrenchment, I

don't see any of these issues that were objected to creating an issue regarding entrenchment at the level at which (1) the amount of the $40,000.00 and (2) the fact that any sale would have to be approved and there would certainly be an opportunity to oppose that. So I don't see the provision with respect to the covenants really something that the Court should alter at this point nor with respect to the fee. The $40,000.00 can get paid. Obviously, that's without prejudice to raising issues with respect to the balance of the fee or the covenants in that section that was discussed earlier or any other issue at the final. But for purposes of the interim I will grant the relief, overrule the objections and you may mark up and then submit the order after showing it to counsel if any counsel are involved in the marking up.

MS. GOLDSTEIN: Yes, Your Honor.

THE COURT: Now, a hearing date for the final.

MS. GOLDSTEIN: Yes.

THE COURT: I'll give you April 17th at two o'clock.

MS. GOLDSTEIN: Thank you, Your Honor.

THE COURT: That is a Thursday. You can fill in whatever other appropriate dates for responses, etc.

MS. GOLDSTEIN: Okay.

THE COURT: Now, I am assuming that I will handle the balance of the cash collateral DIP loan. Obviously, if that changes then you will be notified and take it from there.

MS. GOLDSTEIN: Yes, Your Honor, we're making that assumption. We'll notice it for your Court for April 17th at two o'clock and thank you very much, Your Honor.

THE COURT: All right. Thank you.

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I certify that the foregoing is a transcript from an electronic sound recording of the proceedings in the above-entitled matter.

CARLA NUTTER

Dated: April 8, 2008